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Nathan Jensen

The Multinational Corporation Empowers the Nation-State

In the next ten years, who will win and who will lose from globalization? In thinking about this question, I avoid speculating on the broad impact of globalization on economic outcomes. Instead, I limit my treatment to the impact of multinational corporations (MNCs) on developed and developing countries, especially how competition to attract firms affects domestic politics and national economies.

The literature on the direct impact of multinationals on national economics and the determinants of multinationals' foreign direct investment yields two general findings. First, the independent impact of multinationals on domestic society remains quite limited. Multinationals have become the villains in movies and the engine of progress in the eyes of many conservative pundits, but their real effect is less dramatic. At most, the impact of multinationals is conditioned by domestic policies and domestic institutions. In countries with high levels of human capital and strong domestic competition policies, multinationals can be vehicles for technology transfer, economic growth, and ultimately increased wages. Conversely, in countries with domestic institutions and policies that provide avenues for rent-seeking and reduce competition, MNCs can affect the economy negatively. Rather than making domestic politics irrelevant, multinationals magnify the importance of good governance.

Second, scholars have documented increased competition to attract MNCs.[1] Politicians and pundits in both developing and developed countries claim they need to lower the levels of capital taxation to attract multinationals, even though little systematic evidence exists that the decisions of multinationals are dominated by taxation policies. Corporate income taxes may affect the distribution of income within a society, but they have little impact on the distribution of foreign direct investment (FDI).

My prediction on the future winners and losers from globalization loosely follows from these two developments. The winners will be those who can harness the benefits of globalization and manage the distribution of costs; benefits will closely follow government policy and not rely directly on the globalization of production. Ironically, the countries that lower their levels of corporate taxation in an attempt to take advantage of globalization are, I expect, the ones that will be least able to provide the environment necessary to reap the rewards of multinational corporations.

Walmart and welfare. The promotion of foreign direct investment has become a central development strategy for developed and developing countries alike.[2] Most countries have dedicated agencies to promote FDI, running ads such as "Invest in Singapore" in the *Economist* and *Wall Street Journal,* while multilateral organizations such as the World Bank actively promote the attraction of FDI as a development strategy.[3] Indeed, FDI, like the promotion of trade, is generally viewed favorably by academic the economics community.

Is the evidence on the positive impact of FDI on economic development clear? Not quite. While there is little evidence that FDI damages national economies, scholars have struggled to find a strong independent impact on economic development.[4] The growing consensus in the literature is that the benefits of FDI are conditional on host economic conditions.[5] For example, one influential series of papers finds that FDI has a substantial positive impact on economic growth in countries with high levels of human capital.[6] Countries require the necessary "absorptive" capacity for technology transfer to be feasible, including a skilled workforce to use technology for production.[7] Other studies find that the impact of FDI is conditional on trade policy,[8] institutional capacity and bureaucratic efficiency,[9] public expenditures,[10] government intervention into market failures,[11] and the development of domestic financial markets.[12] Yet these policies or practices are endogenous to higher levels of economic growth, which are independent of FDI. The same policies that promote economic growth are the policies that harness FDI's potential. Globalization of production increases the benefits of good governance, but not the fundamental relationship between domestic politics and economic performance.

Trickle-in economics. Some argue that the competition for capital transforms governance by sparking fiscal wars to attract investors with generous tax rates and investment location incentives.[13] One example is Biella, Italy, where government revenues were used to provide financial incentives to attract textile manufacturing. The logic was probably to draw scarce international capital in order to stimulate local production and create jobs. I have to guess on this since the historical record is a bit spotty. The year was 1160.[14]

Contrary to assertions in best sellers like Thomas Friedman's *The World is Flat* and what we hear on "Lou Dobbs Tonight," mobile production is nothing new.[15] Using low tax rates or fiscal incentives has a long and sordid history. What has possibly changed is that governments and candidates on the left—social democratic governments in Europe and John Kerry's presidential campaign, for

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example—have joined the right in arguing for lower corporate tax rates. Their argument differs from the classic argument of the right in that these new adherents maintain that low taxes are necessary in order to attract foreign capital and limit the "outsourcing" of domestic capital. A consensus, albeit for different reasons, has emerged on the need to lower corporate tax rates.

However, the academic literature on the relationship between corporate tax rates and FDI inflows does not support this conclusion. On the contrary, there are theoretical reasons why we would expect multinationals to be less sensitive to rates of capital taxation than other forms of investment. The major innovation in the literature on FDI in the 1960s and 1970s was modeling FDI as a response to market imperfections.[16] Simple models of multinationals flocking to low-tax countries were cast aside before most of our students were born.

Tax rates can matter. Ceteris paribus, multinationals will prefer low corporate tax rates to high tax rates, and tax policy could tip the scale when comparing two very similar locations. Important scholarship finds that tax rates do affect multinationals' FDI and production decisions.[17] Yet on balance taxes do not matter for market-seeking FDI or for countries with high per capita incomes.[18] As a comprehensive review of the existing literature on taxes and FDI states:

> Tax policies are obviously capable of affecting the volume and location of FDI, since all other considerations are equal, higher taxes reduce after-tax returns. Of course, all other considerations are seldom equal. Countries do not differ in their tax policies, but also in their commercial and regulatory policies, market size, natural endowments, and human capital. All these factors influence the desirability of an investment location.[19]

This review is supported by numerous surveys of multinational firms. In a 2002 survey, the World Bank's Multilateral Investment Guarantee Agency found that firms selected location based in part on tax rates, but that national and state taxes ranked 11th and 14th, respectively, as the most important location factors.[20]

Though taxes remain a relatively minor determinant of FDI inflows, other factors such as the protection of property rights and security of investment from expropriation are important determinants of FDI. Considerable controversy remains on the specific institutional structures that protect property rights, but numerous recent works have focused on the role of political institutions in reducing risks for multinationals.[21] Government policies that attract FDI, such as education policy and physical infrastructure investment, require tax revenues, and companies place more importance on these factors than on availability of low taxes. Thus how governments use their tax revenue may be more important than tax rates.

Countries that can accumulate high levels of human capital, provide for robust economic growth, protect private property, and provide a low tax environment will attract FDI inflows. In short, the same policies that allow for a favorable business environment for domestic firms are those that attract FDI.

Firms and the future. My predictions run counter to the melodramatic rhetoric of (or about) globalization. Policies that have already created wealth, poverty, income inequality, economic insecurity, and the like are pretty much the same policies that will determine these outcomes in the future. Globalization has changed the rewards to good government, but in a way that actually enhances the role and importance of the nation-state.

Finally, I want to go out on a limb and make one observation that does not necessarily follow from the rest of this essay. Some scholars have documented the negative impact of globalization on the middle class and on middle-income countries.[22] I predict that many of the serious issues that affect individuals' income and wealth in rich countries (for example, changing demographics putting pressures on social security and health care costs) and those confronting developing countries (for example, attempts to improve physical infrastructure and spurn human capital accumulation) will require government financial support. Societies that ignore this bunk globalization rhetoric and fiscal competition chatter, and continue to maintain higher levels of corporate tax rates will be more capable to respond to these issues. The citizens of these countries will be the globalization winners.

Notes

1 See Li (forthcoming).
2 Moran 1998.
3 The World Bank has dedicated its recent World Investment Report (2005) to "A Better Investment Climate for Everyone."
4 Görg and Greenaway 2004.
5 Balasubramanyam, Salisu, and Sapsford 1999. See also Garrett 1998 and Boix 1998 for a broader argument.
6 Borensztein, Greorio, and Lee 1998; Glass and Saggi 1998; Li and Liu 2005; and Xu 2000.
7 Durham 2004.
8 Balasubramanyam, Salisu, and Sapsford 1996.
9 Olofsdotter 1998.
10 Le and Suruga 2005.
11 Hoekman 2004.
12 Alfaro et al. 2004.
13 See Jensen (forthcoming) and Li (forthcoming) for a survey of some of these arguments.
14 I shamelessly borrow this example from Wells 1999, 5.
15 Friedman 2005.
16 Kindleberger 1969; Caves 1971; Dunning 1977, 1981; Hymer 1976.

17 Altshuler, Grubert, and Newlon 2001; Devereux and Griffith 1998; Hines 1997; Gordon and Hines 2002.
18 Mutti 2003.
19 Morisset and Pirnia 1999, 5.
20 MIGA 2002.
21 One controversy is over the impact of democratic political institutions on multinationals' investment decisions. See Jensen 2003, forthcoming and Li and Resnick 2003. Recent research by Li (forthcoming) finds that countries with poor property rights protections offer generous tax incentives to compensate for this disadvantage.
22 See, for example, Garrett 2004.

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David C. Kang

Why China's Rise Will Be Peaceful: Hierarchy and Stability in the East Asian Region

Will China's expected emergence as the predominant state in East Asia result in hierarchy or balancing?[1] At least three major bodies of literature predict that a rising China will be destabilizing. Realpolitik pessimists see China's rise as inherently so. John Mearsheimer writes that if China threatened to dominate the entire region, "It would be a far more dangerous place than it is now . . . Engagement policies and the like would not dull China's appetite for power."[2] Power transition theorists also see rapidly rising power as a likely cause of conflict. Robert Powell writes that, "A rapidly shifting distribution of power combined with the states' inability to commit to an agreement can lead to war."[3] Finally, those who focus on signaling emphasize that an authoritarian state has more difficulty in making credible statements about its intentions than a democratic state.[4]

However, China has already been growing rapidly for almost three decades, and there is little evidence that the region is devolving into balancing, or that China's rise is causing undue alarm.[5] Surely, given the anticipatory nature of the pessimistic arguments—that states prepare for future contingencies today—China's growth should already have prompted a reaction from East Asian states. Stability is also not the result of the United States acting as an offshore balancer, attenuating regional conflicts and counterbalancing Chinese power, uniformly welcomed by East Asian states.[6] Only Taiwan, and perhaps Japan, clearly rely on a U.S. security umbrella to balance Chinese power. In deciding how closely to align with either China or the U.S, states can choose to align tightly with the U.S., tightly with China, or a position somewhere between the two. While no state is completely allied with China, many states are at least accommodating its rise (fig. 1). States such as Vietnam, Thailand, the Philippines, and even South Korea could align much more strongly with the United States, but they have chosen not to do so. Indeed, the case of East Asia belies the notion that some states are "too small to balance." With a potential offshore balancer in the United States, even small states have a choice about whether or not to try to balance rising power. If Taiwan, with only 22 million people and close geographic proximity to China, can seek to balance because of a U.S. umbrella, then all the other states in East Asia could as well. If my argument is right, the direction of states' alignments will move towards China and away from the United States, even though they may remain hesitant to clearly choose one side or the other.

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